

***United States Court of Appeals  
for the Second Circuit***



**APPELLEE'S BRIEF**





75-4162

*Signed*

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IN THE UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

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SEYMOUR SILVERMAN,  
v. Petitioner-Appellant

COMMISSIONER OF INTERNAL REVENUE,  
Respondent-Appellee

HELEN SILVERMAN,  
v. Petitioner-Appellant

COMMISSIONER OF INTERNAL REVENUE,  
Respondent-Appellee

JACK SILVERMAN,  
v. Petitioner-Appellant

COMMISSIONER OF INTERNAL REVENUE,  
Respondent-Appellee

FRANCES SILVERMAN,  
v. Petitioner-Appellant

COMMISSIONER OF INTERNAL REVENUE,  
Respondent-Appellee

*B*

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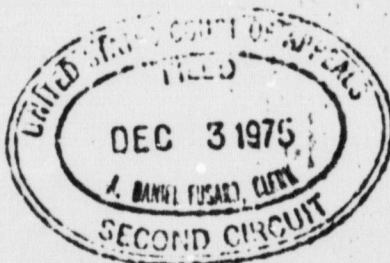
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ON APPEAL FROM THE DECISIONS OF THE UNITED STATES TAX COURT

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BRIEF FOR THE APPELLEE

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v.

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ON APPEAL FROM THE DECISIONS OF THE UNITED STATES TAX COURT

---

BRIEF FOR THE APPELLEE

---

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court clearly erred in its finding of the value of the Class B common stock of Modern Maid Food Products, Inc., for gift tax purposes.



STATEMENT OF THE CASE

The Commissioner of Internal Revenue determined that gift tax deficiencies existed in the total amount of \$751,979.40, for the taxable year 1968. (R. A312.)<sup>1/</sup> These cases were consolidated for purposes of trial. The opinion of the Tax Court (Judge Queally) is reported as P-H Memo T.C., par. 74,285 (1974). (R. A331-A337.) The decisions were entered on May 20, 1975. Taxpayers' notice of appeal was filed on July 21, 1975. (R. A2.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The material facts may be summarized as follows:

Modern Maid Food Products, Inc. (Modern Maid), was engaged in the business of manufacturing breadings and batter mixes for use by processors of shrimp, fish and poultry, and in the business of manufacturing prepared flour mixes for mass feeding outlets such as hospitals, restaurants and hotels. As of April 22, 1968, it had outstanding 2,160 shares of voting common stock and 1,400 shares of five-percent cumulative nonvoting preferred stock. Of this stock, Jack Silverman held 1,284 common and 285 preferred; Seymour Silverman had 645 common and 430 preferred (R. A16.)

On July 31, 1968, Modern Maid was recapitalized. The authorized number of preferred stock was increased to 25,200 shares, and two new classes of stock were created: voting Class A common stock (21,600 shares) and nonvoting Class B common stock (86,400 shares). These two new classes of common stock were not redeemable, and were identical in all respects, except that the Class B common

<sup>1/</sup> "R." references are to separately bound record appendix.

stock was nonvoting. Each share of previously outstanding common stock was exchanged for 10 shares of Class A common stock, 40 shares of Class B common stock, and 11 shares of preferred stock. (R. A16.) On August 12, 1968, 4,790 shares of unissued Class B common stock were sold, subject to restrictions, to select employees and associates at \$10 per share.

The gifts of the nonvoting Class B common stock, the valuation of which is at issue, were made as follows: On August 21, 1969, Jack Silverman made gifts in trust for the benefit of his children of 51,360 shares; On September 24, 1968, Seymour Silverman made gifts in trust for the benefit of his children of 25,800 shares (R. A329-A330.) The wives consented to report one half of each gift for tax purposes (Sec. 2513, Internal Revenue Code of 1954 (26 U.S.C.)).

To finance expansion, in March of 1969, negotiations were initiated by Modern Maid with Ladenburg, Thalman & Company, investment bankers, with a view towards the sale of stock in a public offering. (R. A14-A17.) On June 16, 1969, the company was recapitalized, new voting common stock was created and each share of outstanding Class A common stock was exchanged for 7 shares of new common stock, and each share of outstanding Class B common stock was exchanged for 6.5 shares of new common stock. (R. A320-A322.) There were no public sales of the common stock of Modern Maid prior to the underwriting in 1969 by Ladenburg, Thalman & Company (R. A327.)



Taxpayers in 1968 filed gift tax returns, valuing the gifts of Class B common stock at \$10 per share. In his notice of deficiency, the Commissioner of Internal Revenue determined that the stock had a value of \$48 per share. At trial, the Commissioner reduced his valuation to \$25 per share. Also, taxpayers at trial argued that the valuation of \$10 per share was too high, claiming a value of not more than \$5 per share.

At trial, both sides presented experts. The Tax Court, however, adopted neither the appraisal methods suggested by the Government nor by the taxpayers. (R. A311.) But rather, being cognizant of the "realities of the situation", the court adopted the taxpayers own approach to the valuation of the Class B common stock, utilized in the second recapitalization. In that recapitalization, the Class B common stock was given a value equal to 65/70ths of the value of the Class A common stock. This ratio was applied to the fair market value of the Class A common stock which at the time of the gifts was found by the Tax Court to be \$40 per share, ten times average earnings, resulting in a fair market value of \$37 per share for the Class B common stock. (R. A335-A336.) Thus, the Court's finding sustained the Commissioner's lower valuation of \$25 per share.

From this determination, taxpayers appeal.

SUMMARY OF ARGUMENT

The issue presented is whether the record supports the Tax Court's finding that the Class B common stock of Modern Maid transferred by the taxpayers to their children had a fair market value on the material valuation dates of not less than \$25 per share. Although both the Government and the taxpayers produced experts, the Tax Court adopted neither the appraisal methods suggested by the Government nor by the taxpayers. But rather, focusing on the "realities of the situation", the court adopted the approach to valuation which was utilized by the taxpayers in a recapitalization of the corporation a few months after the gifts were completed. The Tax Court was not so bound by the expert opinions that it could not make an independent finding on the substantial evidence presented. The finding of value is certainly not clearly erroneous and should be affirmed.

ARGUMENT

THE TAX COURT'S FINDING THAT THE STOCK  
HAD A VALUE OF NOT LESS THAN \$25 PER  
SHARE IS SUPPORTED BY THE RECORD

This appeal involves the valuation for gift tax purposes of 77,160 shares of Class B common stock which taxpayers transferred to their children. The Commissioner's determination of deficiencies in gift taxes was based on his finding that the fair market value on the material dates of the stock transferred was not less than



\$25 per share.<sup>2/</sup> The Tax Court sustained the Commissioner's determination of \$25 a share, finding that the gifted shares had an actual value of \$37 per share. Since the valuation of stock is a factual determination, a reversal is warranted only if the Tax Court's finding is clearly erroneous. Elverson Corp. v. Helvering, 122 F. 2d 295 (C.A. 2, 1941). A finding is clearly erroneous when "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." Commissioner v. Duberstein, 363 U.S. 278, 291 (1960). Section 2512 of the Internal Revenue Code, Appendix, infra, provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. In general, the value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts. Treasury Regulations on Gift Tax §25.2512-1, Appendix, infra.

<sup>2/</sup> The Government in its statutory notice of deficiency valued the Class B common stock at \$48 per share; however, at the trial, the Government contended the stock had a fair market value of \$25. Taxpayers erroneously assert that since the Commissioner changed his position after issuing the deficiency notice so as to reduce the amount of the claimed deficiencies, the burden of proof was shifted to the Commissioner to establish the value of the Class B common stock. While this argument as to burden of proof may be applicable where the Commissioner changes his position so as to assert increased deficiencies, it does not apply where the Commissioner's change in position, as here, operates in the taxpayer's favor. McMurtry v. Commissioner, 203 F. 2d 659 (C.A. 1, 1953); Marx v. Commissioner, 179 F. 2d 938 (C.A. 1, 1950); Estate of David Smith, 57 T.C. 750 (1972); Farber v. Commissioner, 43 T.C. 407 (1968); Fada Gobins v. Commissioner, 18 T.C. 1139 (1952), aff'd per curiam, 217 F. 2d 952 (C.A. 9, 1954).

If, as in this case, actual sale prices of shares of stock are lacking, the fair market value is to be determined by considering relevant factors, including the company's net worth, prospective earning power, values of stocks of comparable companies and the degree of control of the stock to be valued. Treasury Regulations on Gift Tax, §25.2512-2, Appendix, infra.

Particularly apposite are the remarks of Judge Learned Hand in Elverson Corp. v. Helvering, supra, p. 298:

The value of the shares depended, as all value does, upon their future earning power, obviously a highly speculative matter as to which no forecast is much better than a guess. We cannot say that the figure taken was so unreasonable that we must upset it; an attempt by us to fix another would not be likely to strike nearer the unattainable mark.

The analysis by the Government's expert, Hugh A. MacMullan III, fully supports the Tax Court's decision of \$25 per share. MacMullan formulated his opinion by employing three approaches which enabled him properly to weigh the relevance of the company's business, its earnings and the value of its assets. (R. A88-A102.) Because of the difficulty of attempting to relate these factors in the abstract, five comparable enterprises were selected as guides. Although it was not possible to find completely comparable companies, the selected companies were as nearly comparable to Modern Maid as MacMullan could obtain from data published in standard financial services.

MacMullan premised his analysis on viewing the subject company not only from the prospective provided by financial data but also from its marketing position in the industry. Sales



revealed a growing, stable enterprise, which increased from \$8,255,805 in 1966 to \$13,478,372 in 1968. (R. A325.) Earnings, considered to be most determinative of the value of closely held stock (Amerex Holding Corp., 37 B.T.A. 1169 (1936), aff'd per curiam, 117 F. 2d 1009 (C.A. 2, 1941)), rose from \$2.66 per share to \$5.87 per share in the same period. (R. A326.) See Tennessee Prods. Corp. v. United States, 107 F. Supp. 578 (Ct. Cl., 1952). Book value as of December 31, 1967, was approximately \$12 per share, and had increased to \$15.55 by June 30, 1968 and to \$18.78 by December 31, 1968. (Ex. Q.)<sup>3/</sup> Modern Maid paid dividends on its preferred stock from 1964 to 1968, inclusive, and paid dividends on its common stock from 1964 to 1967, inclusive.<sup>4/</sup> The company had a marketing area extending throughout the United States. And, in addition, the company's facilities were operating at capacity, making the company's officers expansion minded. (Tr. 14, Vol. 1.)

<sup>3/</sup> Although the value of closely held stock is presumed to be never less than its book value, taxpayers contend a value of less than \$5 per share. Any valuation must demonstrate unusual economic conditions to reflect a closely held stock value at less than current book value. See Conway, Valuation of Stock in a Close Corporation for Estate Tax and Gift Tax Purposes, 14 Wash. Res. L. Rev. 188, 191 (1963).

<sup>4/</sup> As discussed in Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, where actual or effective control is involved, the dividend factor is not a material element in the valuation approach since the controlling group, here the Silverman family, can manipulate the dividend payments to suit the shareholders' objectives and may distort the net income of the company by substituting salaries and bonuses for dividends. For example, in the instant case, the Silverman family effectively shifted the dividends from the common stock to the preferred stock with the issuance of additional preferred stock in 1968. (R. A31.)

Further, the company's operations were balanced (60-percent Food Services Division and 40-percent Food Processing Division (Tr. 34, Vol. 1. thereby limiting the overall effects of a fall in demand for either of the company's products. But most significant, despite the competitive conditions and the lack of novelty in Modern Maid's products, sales and earnings had steadily increased.

MacMullan's first method was the return on net worth approach. Here the return that Modern Maid was making on its net worth was compared to the normal industry return (i.e., average return that the five selected comparable companies had to their net worth). The excess (i.e., actual return of Modern Maid in excess of the normal return for Modern Maid) represented the earnings related to the assets of the company (goodwill) other than those included in net worth. This excess was capitalized at a higher rate of return and the resultant value was added to the net worth to determine the total value of the company. This method produced a value of \$5,200,000. (R. A92-A93.)

The second method of valuation was the price earnings ratio approach. (R. A94.) This approach compared the earnings of the subject company to the earnings of comparable publicly held enterprises having a determinable value through the price of their stock. The five selected comparable companies had a price of 14 times earnings. (It should be noted that in 1969 the public offering price of Modern Maid stock was \$12 per share, which was 14.4 times the 1968 earnings.) Applying this rate to Modern Maid's earnings for the year ending December 31, 1967 produced an amount of \$7,990,000 after proper adjustments. (R. A94-A95.)



The third method was the comparable public enterprise approach (R. A97), which was similar to the price-earnings ratio approach except that it considered net worth and sales in addition to earnings. Multipliers--which were derived by an analysis of the sales, earnings and net worth of the comparable companies--were applied to the company's earnings, net worth and sales. This approach yielded a value for the company of \$7,000,000. (R. A97-A98.)

MacMullan then correlated the three approaches because, although each of the three possessed merit, none could be considered any more than a tool used in arriving at the fair market value of the subject stock. (R. A100.) In his opinion, the total value of all Modern Maid stock was estimated to be \$7,000,000. From this, the value of the preferred stock was subtracted, resulting in a value for the common stock of \$40 per share. A 25-percent discount was utilized for minority interest, which reduced the value to \$30 per share. And, also, a reduction of 16-2/3 percent was made to distinguish the two classes of common stock, which yielded a value of \$25 per share for Class B common stock. (R. A101-A102.)

The Tax Court appraised the share at a value exceeding that determined by the Commissioner's expert, though not for the same reasons. (R. A334-A337.) A "yardstick" provided by the taxpayers was utilized by the court. A few months after the gifts, June 16, 1969, the taxpayers approved a reorganization whereby each share of the Class A common stock was exchanged for 7 shares of the new common stock and each share of the Class B common stock was

exchanged for 6.5 shares of the new common stock, thereby attributing to the Class B common stock a value equal to 65/70ths of the value of the Class A common stock. This ratio was applied by the Tax Court to the value of the Class A common stock, as of the date of the gifts, which was found by the court to be \$40 per share, ten times average earnings (R. A327) suggested by taxpayers' experts (R. A49, A61); consequently, the fair market value of the Class B common stock was \$37 per share on the relevant dates.

Taxpayers have not objected to this 65/70 exchange ratio of Class B common stock to Class A common stock, nor have taxpayers produced the only witness who could provide a credible and thorough analysis of the value of Modern Maid stock, i.e., Landeburg, Thalman & Company, the underwriter of taxpayers' public offering of stock in 1969. (Tr. 136, Vol. 2.) But, rather the taxpayers contend the Tax Court erred in considering the value attributed to the Class B common stock as of the date of the agreement with Landeburg, Thalman & Company, subsequent to the gifts.

Contrary to the taxpayers' contention, the Tax Court did not value the subject stock as of a date subsequent to the dates of the gifts. Rather the court merely referred to the 1969 reorganization to determine what was the relative value of the Class B common stock to the Class A common stock. Although the value of the Class A common stock and the Class B common stock could have appreciated by this subsequent date, the relative value of the two classes of stock to each other would not have varied. And, thus, taxpayers would have this Court rely upon experts who disagree not only on the methods of valuing the subject stock but also on the relevant factors to be considered, even though there



is available to this Court a "yardstick" which taxpayers themselves, and the Tax Court, have accepted as correct. Although the evidence of competent impartial expert witnesses should not be arbitrarily ignored, clearly a court is not bound by the opinion of experts where there is substantial evidence in the record to support the court's decision.<sup>5/</sup> Fitts' Estate v. Commissioner,

237 F. 2d 729 (C.A. 8, 1956); Helvering v. Nat. Grocery Co., 304 U.S. 282 (1938). It is within the province of the court "to accept such evidence in toto, in part, or not at all \* \* \*"

The court is not required to surrender its judgment to the judgment of experts. It is the one to determine the facts--not the experts. Gloyd v. Commissioner, 63 F. 2d 649, 650 (C.A. 8, 1933). See Alvary v. United States, 302 F. 2d 790 (C.A. 2, 1962); Webster Investors, Inc. v. Commissioner, 291 F. 2d 192 (C.A. 2, 1961). Implicit in taxpayers' assertion is that they were prejudiced because the Tax Court failed to adopt any of the proffered "formulas." There is no need, however, to formulize the process by which valuation is attained as long as the court makes clear that it actually weighed all the factors. Penn v. Commissioner, 219 F. 2d 18, 21 (C.A. 9, 1955).

Furthermore, subsequent events do serve to show expectations that were entertained on the date of a gift and that the expectations were reasonable. Hyman v. Nunan, 143 F. 2d 425 (C.A. 2, 1944);

<sup>5/</sup> It should be noted that in two decisions upon which taxpayers place primary reliance, Righter v. United States, 439 F. 2d 1204 (Ct. Cl., 1971), and Whittemore v. Fitzpatrick, 127 F. Supp. 710 (Conn., 1954), the eclectic approaches adopted by the courts were completely alien to any proposed by the respondent or petitioners.

Blanchard v. United States, 291 F. Supp. 348 (Iowa, 1968);  
Couzens v. Commissioner, 11 B.T.A. 1040 (1928). Here, as the Tax Court noted, taxpayers intended to transfer control of the company to their children. Gifts of the Class B common stock, however, were only the first step in the fulfillment of that intent. The subsequent exchange of the nonvoting stock for voting stock was the final step in the "giving process." As the Tax Court stated, although this second step may not have been foreseen at the time of the gifts, "this does not mean that a second step in the 'giving process' was not contemplated at some future date, irrespective of that occasion." (R. A331.) The subsequent reorganization mirrors the expectations that were entertained by the taxpayers. The reorganization was not pursuant to the directives of the underwriters as a preliminary step in the public offering. (Tr. 22, Vol. 1.) Rather, the purpose of the recapitalization was to complete the "giving process" prior to the public offering; otherwise, if the second step were subsequent to the public offering, control could only be passed on by an actual transfer of stock, thereby obviously incurring additional gift taxes. Consequently, by utilizing a step transaction taxpayers effectively transferred control without the concomitant increase in gift taxes.<sup>6/</sup> Cf. Commissioner v. Court

<sup>6/</sup> The Commissioner of Internal Revenue in Rev. Rul. 54-13, 1954-1 Cum. Bull. 109, approved the use of recapitalization (Codes Section 368(a)(1)(E) (26 U.S.C.)) for increasing the proportionate stock interest of a valuable management employee as satisfying the business purpose test of Gregory v. Helvering, 293 U.S. 465 (1935), but expressly reserved his opinion as to whether the transaction might constitute a gift, if there should be any disparity in value between the stock surrendered and stock



Holding Co., 324 U.S. 331 (1945). And, thus, to value the subject stock as styled by taxpayers--i.e., "non-voting common stock in a closely held corporation with no marketability, no voice in management, no return on investment, no employment agreement, no right to even attend annual meetings or to receive financial reports"--would be myopic (Br. 15.) The subject stock should be valued as part of the majority control stock. Hyman v. Nunan, supra, Beck v. Commissioner, 15 T.C. 642 aff'd, 194 F. 2d 537 (C.A. 2, 1950).

The gifts of stock cannot be divorced for valuation purposes from the fact of control within the family, and therefore, should not be valued as stock held by an "outsider." Hamm v. Commissioner, 325 F. 2d 934 (C.A. 8, 1963). The gifted stock should be valued as if control "inhered in it." Blanchard v. United States, supra, p. 349. So long as the company was controlled by the family, the gifted stock in actuality was part of the majority interest.<sup>7/</sup> The unreasonableness of a lower valuation is demonstrated by the subsequent exchange of the nonvoting stock for voting stock, in that control was transferred to the formerly "locked in" donees.

The court properly noted that Ladenburg, Thalman & Company would have been the best expert under the circumstances, but taxpayers made the decision not to present its testimony. (R. A334.) Taxpayers' experts did not value the subject stock from a voluntary sale point of view. Surely, to sell the subject

<sup>6/</sup> (continued)

Received. (Rev. Rul. 74-269, 1974-1 Cum. Bull. 87, supersedes Rev. Rul. 54-13, but without changing the principles underlying Rev. Rul. 54-13.) There are no cases determining whether a recapitalization would constitute a gift.

<sup>7/</sup> If the Class B common stock were treated as equivalent to The Class A common stock, taxpayer's expert, Gordon Smith, would have valued the subject stock at \$29.81 per share. (R. A65.)

stock at under \$5 per share, or under \$2 per share as expert Cannon stated, is to sell under compulsion. (See R. A82.) (See also, Tr. 116, Vol. 1.) Such a valuation would be the ideal price for the speculative investor, but not the bargained price envisaged by the gift tax provisions. (See court's remarks, Tr. 136, Vol. 2.) In addition, taxpayers' experts reveal an unfamiliarity with the relevant facts. (R. A61.) For example, expert Wit was unaware of the circumstances of the favorable exchange ratio of Class B common stock to Class A common stock in the 1969 recapitalization (Tr. 66, Vol. 1.)

#### CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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NOVEMBER, 1975.



CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 28<sup>th</sup> day of November, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 2512. VALUATION OF GIFTS.

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

Treasury Regulations on Gift Tax (1954 Code):

§ 25.2512-1 Valuation of property: in general.

Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the value of an automobile (an article generally obtained by the public in the retail market) which is the subject of a gift, is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the donor would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in § 25.2512-6. The value is generally to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of the property. For example, in the case of shares of stocks or bonds, such unit of property is generally a share or a bond. Property shall not be returned at the value at which



it is assessed for local tax purposes unless that value represents the fair market value thereof on the date of the gift. All relevant facts and elements of value as of the time of the gift shall be considered. Where the subject of a gift is an interest in a business, the value of items of property in the inventory of the business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 25.2512-3. See § 25.2512-2 and §§ 25.2512-4 through 25.2512-6 for further information concerning the valuation of other particular kinds of property.

§ 25.2512-2 Stocks and bonds.

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(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the date of the gift.